

SUBMISSION FROM

BUOYANT ECONOMIES

TO THE

FINANCIAL SYSTEMS INQUIRY

Prepared by

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This submission is in two parts. Part A contributes to the stocktake of the results arising from the financial deregulation and Part B provides suggestions for the future operation and regulation of the financial system.

PART A

THE EFFECTS OF DEREGULATION

1. Introduction

This submission deals with the economic effects of deregulation on growth, employment and savings.

The specific aspects of deregulation dealt with include:

- the adoption of the floating exchange rate system; and
- the regulation of banking.

The inclusion of the effects of deregulation upon economic growth, employment and savings in the terms of reference of this inquiry implies that the government recognises that there is a link between the monetary system and the real economy. That is, the real economy is not independent of the monetary or financial system.

It is possible to consider the relationship between the monetary system and the real economy as being similar to the relationship between computer software and hardware. The monetary system is the economy's software that drives its hardware, bringing together resources and capital to produce and distribute products.

The efficiency of the whole monetary/financial system should be assessed primarily upon its effect upon the real economy. Once that is established, we can proceed to consider the efficiency of the components of the system, including the role of the various institutions that make up the financial sector.

1.1 Growth

This submission will consider the causes of the decline in the rate of growth of real gross domestic product. That decline commenced in 1974. The following graph presents Australia's real gross domestic product (GDP) since 1960. From 1960 to 1973, the average growth rate of the Australian economy was about 5 per cent. Figure 1 shows that if that rate of economic growth had been maintained, Australia's real national income would be about 60 per cent higher than it is now.

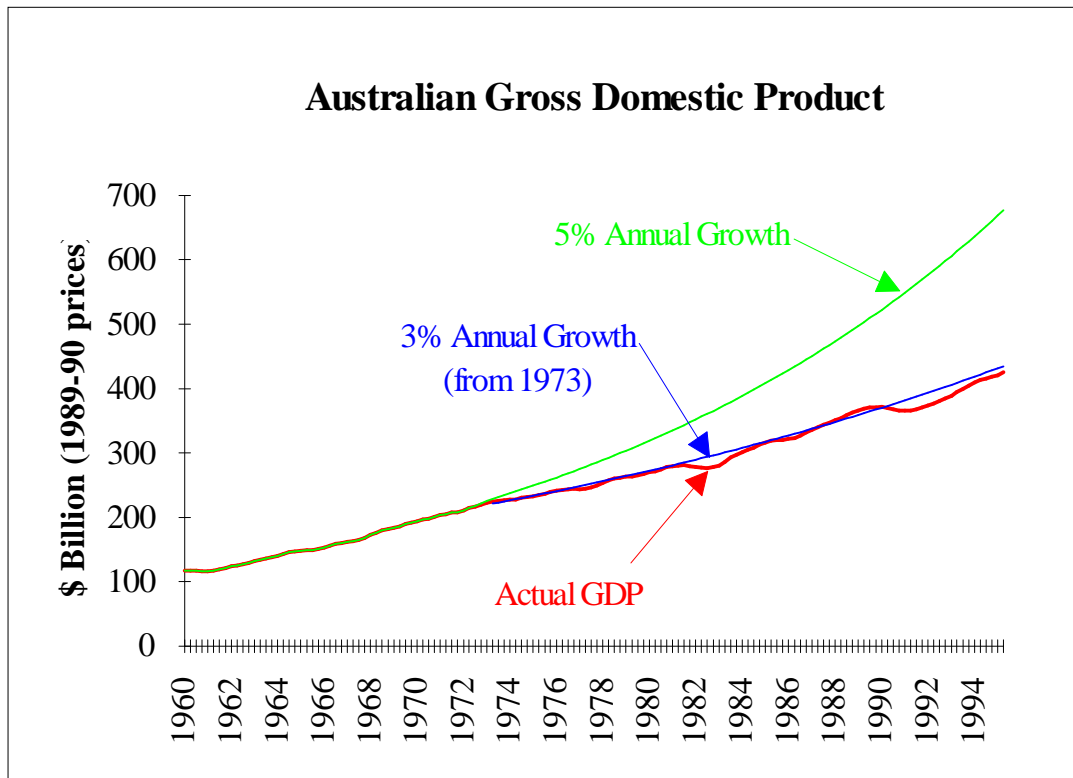


Figure 1.

Since 1973, Australia's rate of economic growth has averaged about 3 per cent. It has fallen below that rate in both the 1982 and the 1990 recessions. A similar change in the rate of economic growth was also recorded in other economies. For example, the United States of America (USA) recorded a decline in its average growth rate from 4 per cent to about 2.4 per cent after 1973. The United Kingdom (UK) did record a decline from an average 3.1 per cent to 1.8 per cent over the same period. However, it has had periods of more rapid growth since 1973. This may be because, as a member of the European Community, it has not always been governed by the floating exchange rate system since then. The growth rate of these countries has declined by about 40% in each case despite the differences in each country's fiscal and other policies.

It would appear that there is a common cause for the decline in the rate of economic growth in Australia, the USA and possibly the UK, since 1973. This would need to have been a major change in economic policy to have such a widespread effect. The major change in economic policy in 1973 was the abandonment of the Bretton Woods arrangements and the floating of the currencies of the USA and other major economies. This submission will explain how such

"deregulation", both in the domestic and foreign economies, has reduced the rate of economic growth in Australia.

1.2 Employment

Unemployment has grown together with the decline in the rate of economic growth. This submission will not deal specifically with the causes of unemployment other than to say that it is linked to the slow rate of economic growth experienced since 1973. Unemployment was seen to rise in Australia in 1974 and has not returned to the pre-1974 levels.

1.3 Savings

Savings is normally defined as that part of national income that is not spent on consumption. I will refer to this form of savings as "consumption savings". In this submission, for reasons that will become clear later, I will be defining savings to occur when national expenditure is less than national income. I will refer also to these as "national savings". I will also use the term "dis-saving" to mean national expenditure that exceeds national income. This dis-saving is equal in value to the current account deficit.

2. Growth and Exchange Rate Deregulation

Milton Friedman¹ wrote:

A system of flexible or floating exchange rates is absolutely essential for the fulfilment of our basic economic objective: the achievement and maintenance of a free and prosperous world community engaging in unrestricted multilateral trade.

If the floating exchange rate system brought about prosperity, we would have expected to see an increase in the rate of economic growth following its wide introduction in 1973. But instead we saw a decline in the rate of economic growth as shown in the following graph for the USA.

Figure 2 compares the gross domestic product of the USA, if it had maintained the pre-float growth rate, with the actual and average growth rates since the float. It reveals that the gross domestic product of the USA would have been more than 40 per cent higher than it is now if it had maintained its pre-float growth rates.

There is certainly no evidence to support Friedman's assertion that a ***floating exchange rates was absolutely essential for a prosperous world community***. Rather, many of the countries that have prospered since 1973, particularly those in South East Asia, have maintained regulated exchange rates.

To understand why economic growth has declined since 1973, it is necessary to consider the effects of the floating exchange rate system upon

the whole economy. Also, it is necessary to understand why the fixed exchange rate system, with all its faults, has been so conducive to economic growth.

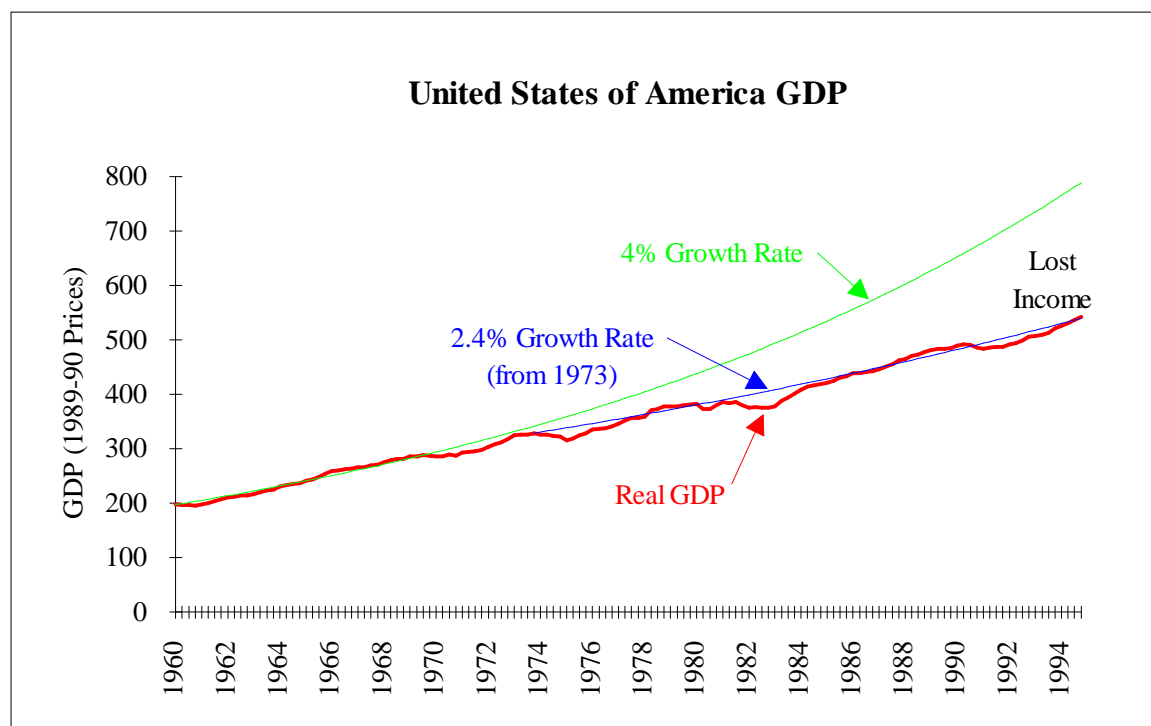


Figure 2.

2.1 Exchange rates and Economic Growth.

Under the fixed exchange rate system, international transactions affected the domestic money supply. For example, in the 1960's, Australia's exports doubled in real terms. Under the fixed exchange rate system, this additional money and income stimulated the domestic economy so that national income doubled, also.

In the last ten years, Australia's exports have again doubled. However, under the floating exchange rate system, such additional exports do not increase national income. The floating exchange rate system requires that foreign receipts and payments are made equal at all times. Any increase in foreign income from exports must be accompanied by an increase in foreign payments, such as for imports or a net capital outflow. The floating exchange rate adjusts the exchange rate to achieve this outcome. The effect of this is clearly evident in Australia in Figure 3.

This graph reveals that exports and imports have been rising as a proportion of GDP since the exchange rate was floated, from around 14.5 per cent before 1983 to 22 per cent of GDP in 1995. Although Australia's nominal exchange rate has declined over this period, the real exchange rate has increased and so created the rise in the relative demand for imports. The real exchange rate is the relative price of domestic products to imports.

Fixed exchange rates were conducive to economic growth because they allowed rises in exports to stimulate demand and raise national income. This income from exports also caused the money supply to rise.

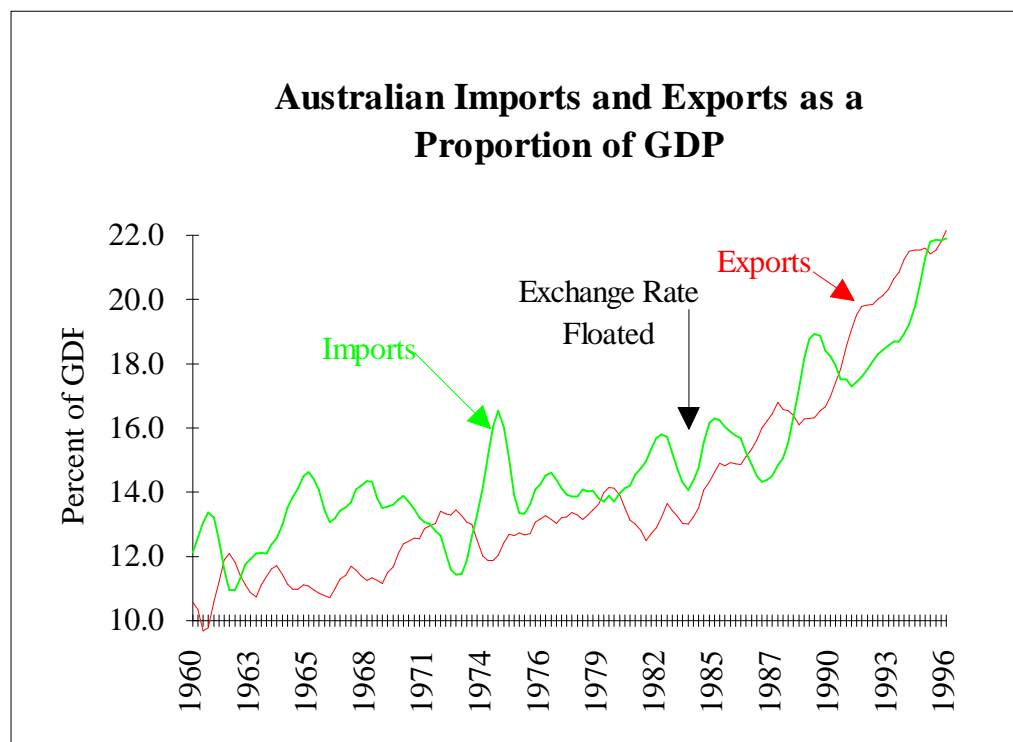


Figure 3.

The change to the floating exchange rate system has prevented increased exports from injecting money into the economy. This has prevented exports from stimulating the economy and contributing to economic growth.

This should not be a surprise. Milton Friedman¹ had described internal monetary independence as one of the benefits of the floating exchange rate system:

In effect, flexible exchange rates are a means of combining interdependence among countries through trade with a maximum of internal monetary independence; they are a means of permitting each country to seek for monetary stability according to its own lights, without either imposing its mistakes on its neighbours or having their mistakes imposed on it.

Not only does this monetary independence mean that countries no longer imposed their mistakes on each other, it means that they can not benefit from their economic successes, such as increased exports. The following diagrams are used to explain the implications of the change from the fixed to the floating exchange rate system.

2.2 The Fixed Exchange Rate System

Figure 4 considers the case of a country with fixed exchange rates. Exports and imports are assumed to be at the amount X_1 on the income axis. The export schedule is given, initially, by the X_1-X_1 line. The import schedule is given by the M_1-M_1 line. Spending on imports is assumed to be determined by national income and the exchange rate (relative prices). There are assumed to be no other international transactions. National income is assumed to be at the amount Y_1 . The equilibrium level of national income (for the export schedule X_1-X_1 and for a given average propensity to import) is shown as the Y_1-Y_1 line.

We then assume an exogenous increase in exports from X_1 to X_2 as shown by the arrow "a". This increase also shifts the export schedule to the right from X_1-X_1 to X_2-X_2 . With the increased income from exports, national income rises, as shown by the arrow "b". As national income rises, imports rise, because spending on imports is assumed to be a fixed proportion of national income, for a given exchange rate. This rise in imports shifts the import schedule to the right as shown by the arrow "c".

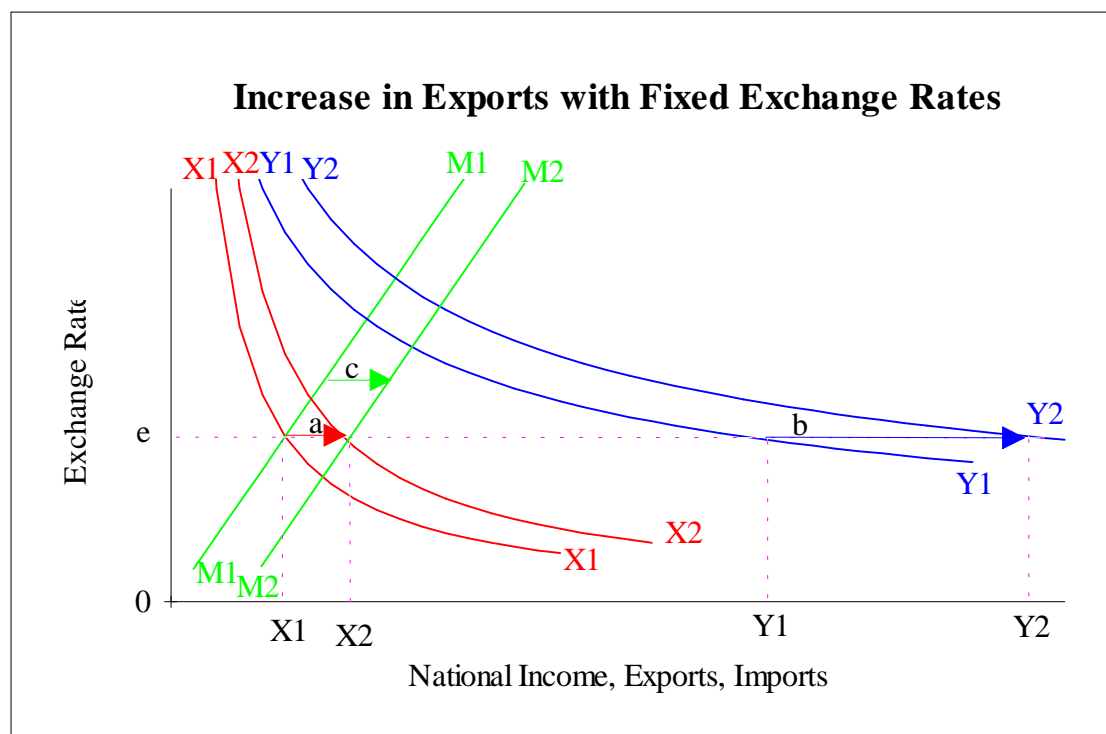


Figure 4.

While income from exports is greater than spending on imports, injections of money and income into the economy will be greater than the leakages of money and expenditure. During this stage, national income will rise. National income will cease to rise when the spending of that income generates imports equivalent to the income from exports. This occurs when national income reaches the amount Y_2 . At that level of income, spending on imports would be at X_2 .

The important point to note from this simple diagrammatic model is that under the fixed exchange rate system, increases in exports can raise national income. This increase in national income comes about from a rise in exports equal to the interval $X1-X2$ and an increase in spending on domestic products which has increased from the amount represented by the interval $X1-Y1$ to that represented by the interval $X2-Y2$. Although exports stimulated the increase in income, the largest part of that increase has come from domestic sales.

2.3 The Floating Exchange Rate System

In Figure 5, we consider the case of a similar country under the floating exchange rate system. Initially, we will assume that the foreign exchange rate market sets the exchange rate at $e1$. Hence imports equal exports at $X1$. National income is Y and spending on domestic products is equal to the interval $X1-Y$.

We then assume an exogenous increase in exports from the $X1-X1$ schedule to the $X2-X2$ schedule. This increase is shown by the arrow "a".

The increase in exports increases the demand for domestic currency on the foreign exchange market. The market responds, automatically raising the exchange rate, as shown by arrow "b", to balance the demand for domestic currency on the foreign exchange market with the supply of domestic currency.

As the exchange rate rises, imports expand as shown by the arrow "c", along the import schedule $M-M$. The market is cleared when the exchange rate reaches $e2$; the exchange rate where exports equals imports at $X2$.

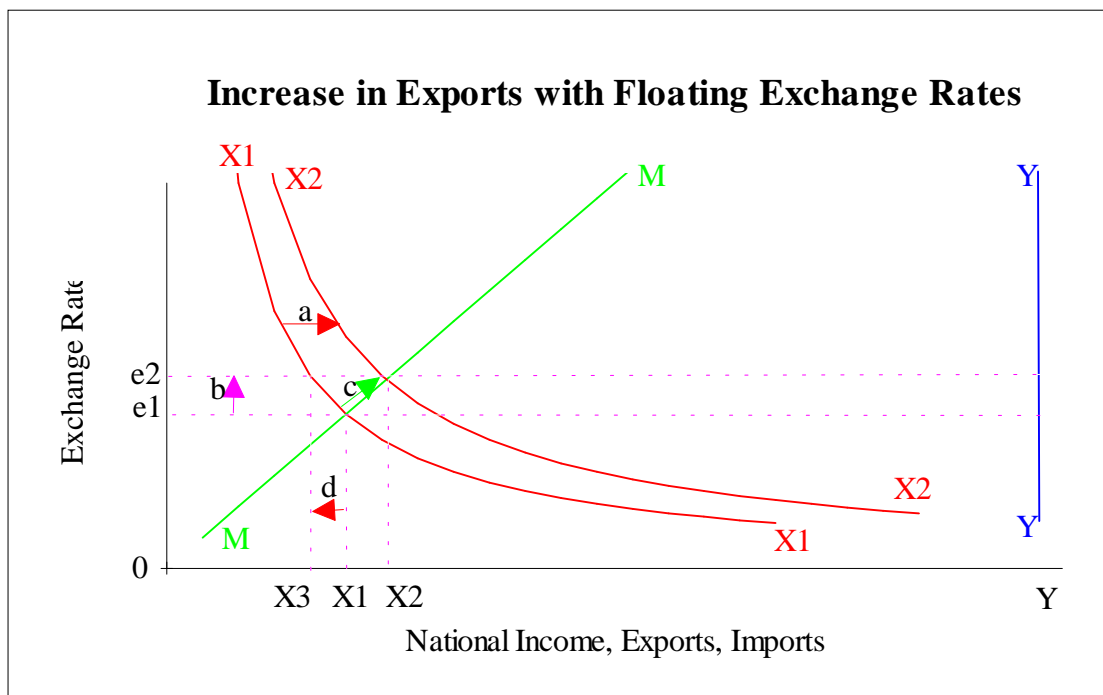


Figure 5.

Although there has been an increase in both exports and imports under the floating exchange rate system, there has not been any increase in national income. The increase in export income, represented by the interval X1-X2, has been offset by a reduction in spending on domestic products from the interval X1-Y to the interval X2-Y. This reduction in income is equivalent to the increase in export income. Hence, despite the increased exports, there is no overall increase in national income.

For there to be any increase in national income there would have needed to have been an injection of additional income and money into the economy. That is, income from exports would have had to exceed expenditure on imports. But, the floating exchange rate system prevents such injections and hence prevents national income from rising. Therefore, national income remains the vertical line shown in the diagram.

The effect of the rise in the exchange rate on the pre-existing exporters can also be assessed from the diagram. The income of the initial exporters declines, as shown by the arrow "d", from X1 to X3. This fall would explain why rural exporters in Europe, USA, Canada and Australia have suffered a decline in income since the exchange rates of their respective countries were floated. Thus the higher real exchange rates have reduced the real incomes of farmers.

Also, the diagram can explain the effect of the floating exchange rate upon the import competing sector. At the higher exchange rate, the income generated from domestic sales declines from the interval X1-Y to the interval X2-Y. The burden of that reduction will be felt in the import competing industries. These are generally manufacturing industries that produce tradable products. Thus the decline of manufacturing industries in Australia and many other OECD countries can be attributable to the introduction of the floating exchange rate system.

While Australia did not adopt the floating exchange rate system until 1983, it did tie its exchange rate to other economies that adopted the system. In 1973, the Australian dollar was tied to the US dollar. Later it was tied to a basket of currencies. Therefore, the Australian economy was susceptible to damage from the appreciation of US and other currencies in the basket.

Australia experienced high rates of inflation at this time that exacerbated its trade problems. It suffered, also, from the decline in rate of growth of demand for its exports because of the lower rates of economic growth experienced by its trading partners.

This is not the first time that an inflated exchange rate has caused unemployment. In 1925 in the UK, John Maynard Keynes criticised Winston Churchill for overvaluing the pound. The overvalued exchange rate of the pound caused the British economy to stagnate, resulting in years of unemployment at over 10 per cent, even before the Great Depression. It was this unemployment that provoked the introduction of assisted passages for migrants from the UK to Australia in the 1920's.

Australia did experience its own internal economic problems in the mid 1970's but the net effect of these does not appear to have reduced the rate of economic growth of the nation below that of its trading partners. Both the USA and UK had negative rates of economic growth in the mid 1970's while Australia's rate of economic growth remained positive throughout this time.

Under the floating exchange rate system, international capital flows can distort the exchange rate, also. International capital flows can keep the exchange rate permanently inflated or may cause the exchange rate to be volatile. Both these effects can be detrimental to economic growth.

A net capital outflow can deflate the exchange rate. This can promote export growth, such as in Japan. A more thorough treatment of the effects of international capital flows upon the economy is available, if required².

Credit growth has provided some opportunity for economic growth. However, the growth of credit, as will be seen later, caused its own problems.

Thus deregulation of the exchange rate has contributed to decline of the rate of economic growth. This has had a serious detrimental effect upon the Australian economy, causing the demise of both exporters, particularly the agricultural sector, and import competing industries, particularly manufacturing. The decline in the relative size of these industries is shown in Figure 6.

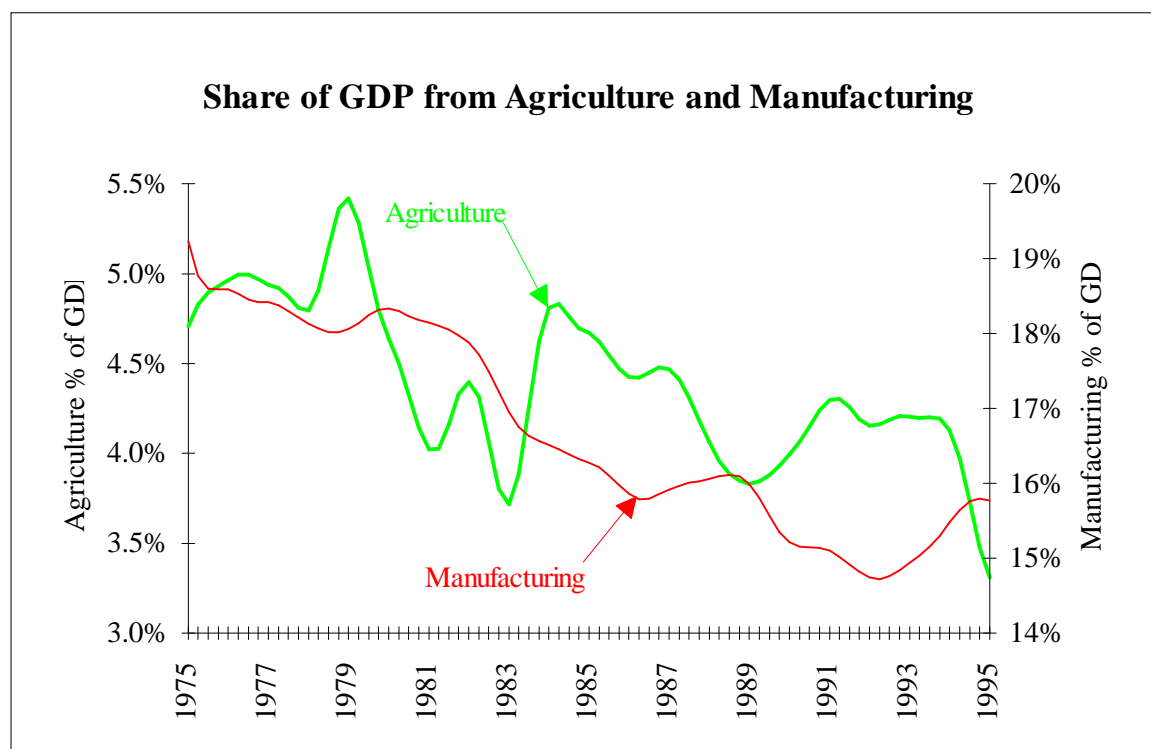


Figure 6.

This decline has contributed to the reduction in the rate of economic growth in the remainder of the Australian economy. Also, it has meant that the only industries that have prospered under this environment are those for which there is no foreign competition, such as service industries.

The low rate of economic growth has reduced the growth of government revenue, also. The lack of employment opportunities has increased the burden upon government to provide social security. Hence, the floating exchange rate system has contributed to the government's tight fiscal environment.

The trend of economic growth since the collapse of the Bretton Woods arrangements and the general adoption of the floating exchange rate system suggests that it will not be possible for Australia to attain sufficient economic growth to provide full employment, while it persists with the use of the floating exchange rate system.

This is because the feature of the floating exchange rate system that provides monetary independence also prevents economic growth from being generated from increased exports. It is not recommended that Australia return to the fixed exchange rate system. A solution that allows a variable exchange rate and facilitates economic growth and full employment is suggested in Part B of this submission.

3. Saving and Exchange Rate Deregulation

As mentioned in the introduction, this paper defines saving to be that amount of national income that is not spent. As national expenditure in Australia is greater than national income, the Australian economy is dis-saving. This has caused current account deficits and raises foreign debt.

To explain how and why this happens, it is necessary to consider some of the basic functions of money.

3.1 Money Constrains National Expenditure

The way the economy works is that the money that each producer and worker earns from selling goods and services to the economy entitles them to buy products up to the value of those that each had supplied or produced. That is, if someone earns \$500 from providing goods or services to the economy, that money entitles them to buy products up to the value of \$500 from the economy. In this way, money constrains national expenditure to the production or income of the economy.

It does not matter how fast the money flows through the economy, everyone who holds it must have first supplied products before they are able to

demand products. The velocity of circulation of money does not change the basic equality of income and expenditure.

When one sector of the economy borrows money from another sector, the lending sector reduces its spending to allow the borrowing sector to spend. Again, money constrains expenditure to income. When the loan is repaid, the borrower reduces their spending to enable the lender to increase their spending. Again, the monetary system constrains spending to income.

But if the economy were to create additional money and allow the participants in that economy to spend it, that money would cause a one-off increase in national expenditure above national income. The initial spender would be able to purchase products without having first supplied products to the economy.

3.2 Bank and Non-bank Credit

When banks lend, they create money which can finance national expenditure to exceed national income. But not all bank lending causes excessive spending. If bank lending were to equal loan repayments to banks, then there would be no increases in the money supply and spending. The act of repaying a loan is a form of saving. It reduces expenditure below income. The act of borrowing from a bank is a form of dis-saving. It increases expenditure above income. If both are equal, there is not growth in spending or in the money supply.

But, if bank lending were to exceed loan repayments, it would cause spending to rise without any corresponding saving elsewhere in the economy. It would cause national expenditure to exceed national income. This would be a case of national dis-saving. It can cause current account deficits and rising foreign debt.

Lending by non-bank financial institution does not have the same effect upon the economy. When a non-bank financial institution lends money, it must already hold that money (usually as a deposit in a bank) before it can lend. When it lends, it transfers its deposit in the bank to the borrower.

If we compared money to tickets to a football match or concert, banks would act as the ticketing agents, issuing new tickets. Non-bank financial institutions would be comparable to scalpers, dealing in tickets that have been issued already by the ticketing agents.

If there were too many tickets issued, one could not attribute blame to the scalpers. They are dealing only in tickets that have been issued. The source of the excess tickets could come only from the ticketing agents.

Banks are the ticketing agents in the economy. They issue money when they increase their lending. As non-bank financial institutions deal only in

existing money. They can lend only what has been saved with them. Hence they can not cause national expenditure to exceed national income. They can not cause dis-saving and current account deficits.

To further illustrate the basic differences between bank and non-bank finance, consider the following examples using simple "T" accounts.

3.2(a) Bank Credit

Case 1a, is assumed to be the initial consolidated balance sheet of the banking system.

Case 1a

Assets	\$B	Liabilities & Equity	\$B
Government Securities	15	Customers' Deposits	90
Foreign Reserves	15		
Loans Outstanding	70	Capital	10
Total	<u>100</u>	Total	<u>100</u>

We then assume that the banks increase their lending by \$10 billion, other things remaining as they were. The effect on the banks' consolidated balance sheet is shown in Case 1b.

Case 1b

Assets	\$B	Liabilities & Equity	\$B
Government Securities	15	Customers' Deposits	100
Foreign Reserves	15		
Loans Outstanding	80	Capital	10
Total	<u>110</u>	Total	<u>110</u>

The \$10 billion increase in lending increases *Loans Outstanding* by \$10 billion to \$80 billion and *Customers' Deposits* by \$10 billion to \$100 billion. Thus, when banks lend, they increase their asset; *Loans Outstanding*, and increase their liabilities; *Customers' Deposits*. Customers' deposits are money. Hence, the bank lending increases the money supply.

We will now assume that borrowers repay \$5 billion of their loans. The effect is shown in Case 1c, below.

Case 1c

Assets	\$B	Liabilities & Equity	\$B
Government Securities	15	Customers' Deposits	95
Foreign Reserves	15		
Loans Outstanding	75	Capital	10
Total	<u>105</u>	Total	<u>105</u>

The loan repayment reduces the banks' assets, *Loans Outstanding*, by \$5 billion. Also, it reduces the banks' liabilities, *Customers' Deposits*, by \$5 billion.

Hence the repayment of loans to banks reduces customers' deposits and the money supply.

3.2(b) Non-bank Credit

In Case 2, we will consider the same transactions in the non-bank sector. Case 2a presents the initial consolidated balance sheet of the non-bank sector.

Case 2a

Assets	\$B	Liabilities & Equity	\$B
Bank Deposits	20	Customers' Deposits	90
Loans Outstanding	80	Capital	10
Total	100	Total	100

We will now assume that the non-bank sector lends an additional \$10 billion.

Case 2b

Assets	\$B	Liabilities & Equity	\$B
Bank Deposits	10	Customers' Deposits	90
Loans Outstanding	90	Capital	10
Total	100	Total	100

When the non-bank sector lends money, they lend their bank deposits. That is, they exchange one asset (a deposit in a bank) for another (a loan). In this example, the non-bank sector reduces their *Bank Deposits* by \$10 billion and increases their *Loans Outstanding* by \$10 billion. Their *Customers' Deposits* were unaffected by the loan.

Thus, non-bank financial institutions are only financial intermediaries, lending money deposited with, or lent to them by their depositors or creditors. They can not lend any more than is saved with them. Nor do their loans constitute an increase in the money supply.

When borrowers repay their loans to non-bank financial intermediaries, the borrowers reduce their holdings of money and increase the money (or bank deposits) held by the non-bank financial sector. This is shown in Case 2c where borrowers repay \$5 billion of their loans.

Case 2c

Assets	\$B	Liabilities & Equity	\$B
Bank Deposits	15	Customers' Deposits	90
Loans Outstanding	85	Capital	10
Total	<u>100</u>	Total	<u>100</u>

While the loan repayment increase the non-bank financial sector's holdings of money, it does not constitute a change in the money supply. The act of repaying the loan transfers money from the borrower to the lender. This increases bank deposits, enabling the non-bank financial institutions to lend this money again.

The difference between bank lending and lending by non-bank financial institutions does have implications for monetary policy. Bank lending has increases the money supply and, therefore, should be regulated. The lending activity of non-bank financial institutions do not affect on the money supply. Hence, for purposes of monetary policy, these do not need to be regulated.

3.3 Monetary Growth from Other Sources

Bank lending is are not the only source of monetary growth. Nor do all sources of money growth cause dis-saving. For example, (as we have already considered above) under the fixed exchange rate system, if the economy were to export more than it imported, then the country would experience a rise in the money supply (assuming no offsetting international capital flows). This money would not cause national expenditure to exceed national income. Rather, it would indicate that national income (from increased exports) exceeded national expenditure. Therefore, monetary growth from exports is achieved through an increase in national savings.

Managing an economy under the fixed exchange rate system requires the balancing of these two basic types of monetary growth. That is:

- the domestic sources comprising mainly bank credit; and
- foreign sources generated mainly from exports (and foreign capital inflow).

Such management usually required the regulation of domestic credit to ensure that it was not excessive. Excessive credit creation would deplete foreign reserves.

When Australia floated the exchange rate in December 1983, it restricted the source of monetary growth that came about from exports and savings. That meant that the only source of monetary growth available to the economy was that which caused dis-savings; namely bank credit.

This has left economists in a dilemma. The economy needs monetary growth to facilitate economic growth and provide employment. But the only source of monetary growth available to it (under the floating exchange rate system) causes current account deficits and rising foreign debt.

There is evidence in Australia, and elsewhere, to show that the current account deficit is equal to the growth in bank credit. Figure 7 plots the current account deficit and the growth of the money supply generated from bank credit in Australia since 1980.

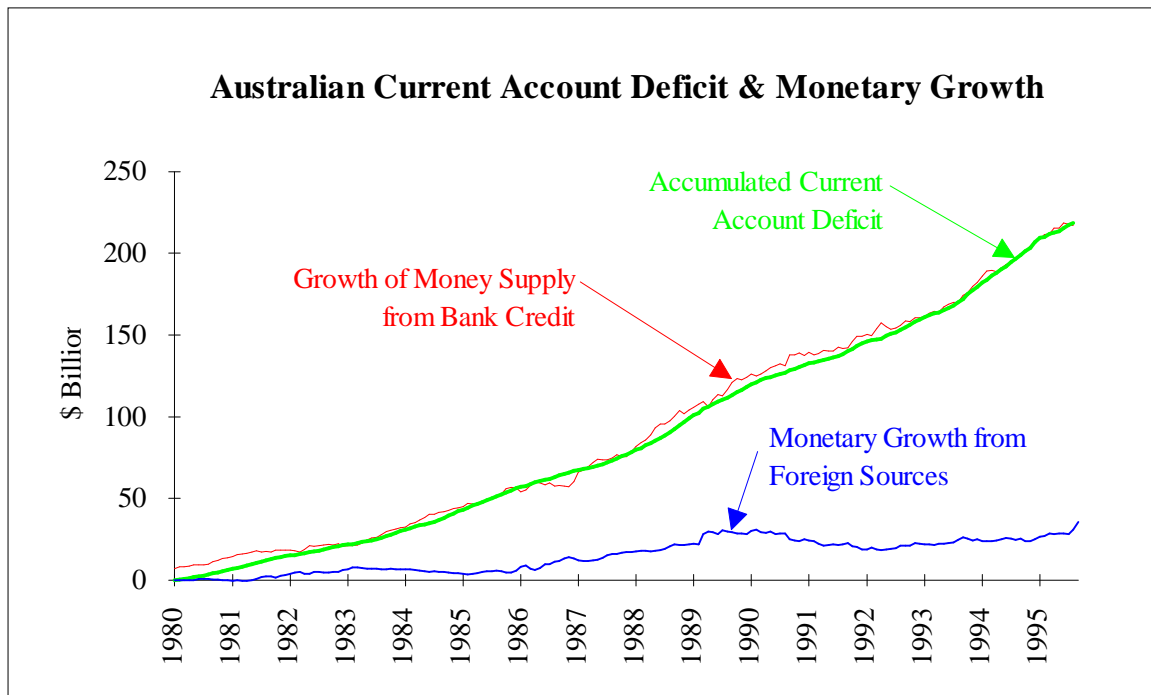


Figure 7.

Included in the money supply shown in the graph is currency, which accounts for about 7 per cent of the monetary growth over this period. The remaining 93 per cent is attributable to trading bank credit, including bank bills.

That part of the growth in bank liabilities attributable to the conversion of savings banks and other non bank financial institutions into banks has been deducted. Also deducted have been changes in the money supply attributable to the Reserves Bank's foreign reserve transactions and those attributable to growth in bank foreign assets (data available since 1985 only). These foreign sources of money are shown separately on the graph.

The graph clearly shows that the money created from bank credit has been equal to the current account deficit, or dis-savings in Australia. Monetary growth from foreign reserves, including bank's foreign assets are shown not to have contributed to the current account deficit.

Figure 7 also reveals that the rate of monetary growth has increased dramatically since the exchange rate was floated. One of the reasons for

this could be that, given that the growth of bank credit no longer depletes the Reserve Bank's foreign reserves, there is less pressure on the Bank to regulate that credit growth.

However, there is also strong evidence to suggest that the current lending guidelines and monetary policy may be ineffective in controlling monetary growth, or dis-saving.

The Reserve Bank employs two forms of official intervention into banking: the prime assets ratio and a risk weighted capital requirement. These requirements are for the purposes of prudential supervision. They are not designed to regulate the amount of bank lending.

3.4 Interest Rates and Monetary Growth

The Reserve Bank use interest rates to regulate the amount of bank lending and the consequential monetary growth. However, this method of regulation has proved to be extremely damaging to the economy. In particular, the high interest rates in the late 1980's had extremely undesirable effects upon the economy. Many businesses were made insolvent and the subsequent recession raised unemployment to levels unheard of since the Great Depression.

The high interest rates did reduce new lending. However, as most loans in Australia have variable interest rates, the higher interest rates also reduced the amount of loan repayments. The reduction in loan repayments was greater than the reduction in new lending. If we consider new loans to be dis-savings and loan repayments as savings, we can conclude that the higher interest rates reduced net savings. That is, they increased dis-saving.

This effect is clearly evident on Figure 8. Interest rates increased in 1988 and 1989. As expected new lending declined as shown by the *Loan Commitments* line. However, despite the declining level of lending, bank deposits increased. This can only mean that the rate of loan repayments declined.

An estimate of loan repayments is also shown in the graph. They are shown to fall dramatically as interest rates increased. They fell much faster than new lending.

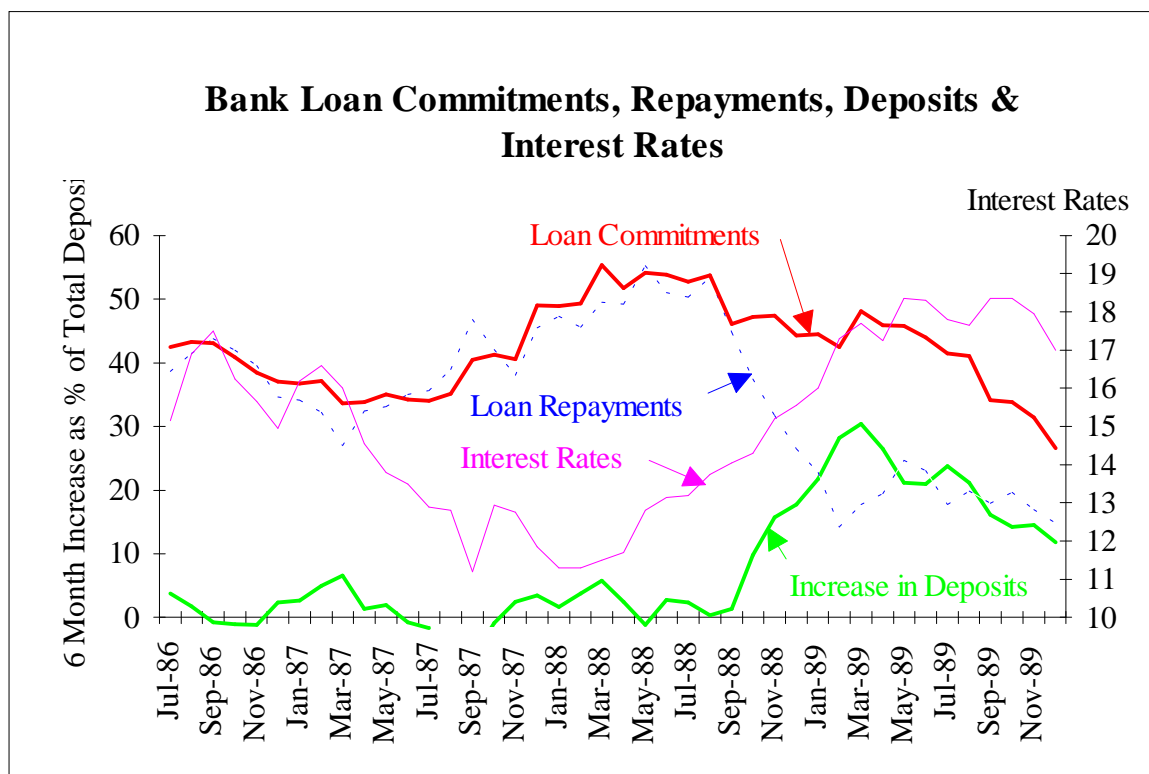


Figure 8.

Therefore, rather than reduce the growth of the money supply, the Reserve Bank's interest rate strategy directly increased the money supply. This increased the level of dis-saving. When the Reserve Bank saw that its interest rates had not reduced the growth of the money supply, it reacted by raising interest rates even higher. This only exacerbated the problem. Thus this indirect, or open market, approach to the regulation of the monetary system has been totally ineffective.

Not only did the Reserve Bank's strategy fail to achieve its objective, it was extremely damaging to the Australian economy. The Reserve Bank is charged with the responsibility of ensuring that its monetary policy "is directed to the greatest advantage of the people of Australia . . ." In this case, its strategy brought about a recession.

There were so many businesses made insolvent by the Reserve Bank's high interest rate strategy that the solvency of the banks was threatened. Some banks did fail. It was only when the banks' themselves were threatened that interest rates stabilised and banks started to significantly reduce their lending and the rate of monetary growth. This reduction in lending was more of a drastic attempt to reduce the banks' exposure to bad debts than a consequence of sound interest rates policy.

The recession of the early 1990's was not a recession brought about by drought or natural causes. It was a recession brought about by monetary policy. It represented what can only be described as the greatest failure in the history of post-war economic policy in Australia.

The Reserve Bank is required to exercise its powers to ensure that monetary policy best contributes to:

- "the stability of the currency of Australia;
- the maintenance of full employment in Australia; and
- the economic prosperity and welfare of the people of Australia."

The Reserve Bank's interest rate strategy failed on all counts. It caused high rates of inflation and an unstable exchange rate. It caused unemployment of over one million Australians and it reduced the economic prosperity and welfare of the people of Australia, causing negative economic growth. It also increased the level of dis-saving and raised foreign debt.

Deregulation did not give the Reserve Bank the powers necessary to achieve its objectives. It removed the Reserve Bank's quantitative controls over bank lending but it did not provide an alternative powers that would enable the Bank to function so as to meet its statutory obligations.

4. Conclusion to Part A

Australia has vast resources, a highly educated and skilled work-force and extensive social and economic infrastructure, capable of supporting a higher standard of living than it currently experiences. Its economic problems of slow growth, high unemployment and rising foreign debt have not been brought about because of a failure in this economic hardware. The failure in the Australian economy has been in its monetary system; the software of the economy.

The monetary system should facilitate and direct the efficient allocation and utilisation of resources in the economy. However, changes to the monetary system have caused the economy to malfunction. It is the monetary system that has brought about the slower economic growth, high unemployment and rising foreign debt.

The changes in the exchange rate system have caused the prices of Australian products to rise, relative to the price of imports. This higher real exchange rate caused a decline in the share of national income spent on Australia products and a rise in the spending on imports. The higher real exchange rate, resulting from the floating exchange rate system, has brought about the demise, also, of the agricultural sector in Australia.

Furthermore, the floating exchange rate system has constrained monetary growth from exports. This is a source of money that would have increased savings and reduced the nation's foreign debt. Its removal has left the economy with bank credit as the only significant source of monetary growth to facilitate economic growth. This source caused dis-savings, current account deficits and rising foreign debt.

The deregulation of the banking system has left the Reserve Bank with inadequate powers to perform its duties. Consequently, bank lending has increased and so increased dis-saving in the economy.

Therefore, the overall effect of deregulation upon the economy has been far from positive. That is not to say that some actions were not needed or that all the changes were bad. There were some positive changes.

The Government acknowledges that the recommendations of the Campbell Report have not achieved the desired outcome in the financial sector nor in the economy. That is why it has called this Inquiry.

Part B

SUGGESTIONS FOR THE OPERATION AND REGULATION OF THE FINANCIAL SYSTEM

This part provides suggestions for the operation and regulation of the financial system. These suggestions relate to the issues raised in Part A of this submission which deals with the economic effects of deregulation.

1. The Objectives of Monetary Policy

The Reserve Bank's objectives as specified in the Reserve Bank Act and mentioned in Part A of this submission is that monetary policy should contribute to:

- "the stability of the currency of Australia;
- the maintenance of full employment in Australia; and
- the economic prosperity and welfare of the people of Australia."

The suggestions presented here take account of these objectives and the procedures of the Reserve Bank in its conduct of monetary policy.

Whatever the Inquiry recommends for the operation and regulation of the financial system, it will have a bearing upon the conduct of monetary policy. The suggestions made here affect the options available to the Bank to conduct monetary policy. They do not extend to advising the Bank on how it is to conduct monetary policy.

2. Non-bank Financial Institutions.

In Part A of this submission, it was explained that the activities of the non-bank financial sector did not affect the money supply. Their liabilities were not money and their actions did not affect the stability of the currency. Therefore, the Reserve Bank does not need to regulate these activities, either directly or indirectly.

Non-bank financial institutions may need to be regulated for prudential purposes, to protect the interests of depositors and other creditors. Hence, it may be appropriate that a regulator be appointed to oversee their activities. However, the Reserve Bank is not the appropriate institution to be their regulator. It has its own objectives which do not include the protection of creditors of non-bank financial institutions.

Although deposit taking non-bank financial institutions may appear to the layman to be functionally similar to banks, technically, they are functionally

different. Bank deposits are negotiable instruments. They are money. The deposits of non-bank financial institutions are not negotiable. They are not money.

A deposit with a bank is only a transfer of one bank's liabilities to another bank. Total bank liabilities are not changed. A deposit with a non-bank financial institution increases the assets and liabilities of the institution and the non-bank financial sector.

As explained in Part A of this submission, when banks lend, they increase their deposits (or other liabilities). These increased liabilities are able to finance additional expenditure that can cause national expenditure to exceed national income. Such expenditure can significantly affect the national economy. It constitutes a dis-saving that causes current account deficits and rising foreign debt.

If a customer borrows money from a non-bank financial institution, they do not cause the institution's deposits to rise. Nor do they increase bank deposits. Such loans do not affect the money supply. They do not cause dis-saving. Non-bank financial institutions can only lend what has been saved with them, either by creditors or shareholders. When they lending creditor's savings, they do not create an economic problem.

The deposits of non-bank financial institutions are not negotiable. If a depositor wants to spend their deposits with a non-bank financial institution, they must withdraw them. That is, they must convert their deposits into money before they can spent it. Even when a non-bank financial institution allows its customers to use cheques to transfer funds, the funds directly transferred by these cheques are the deposits of the non-bank financial institution with its banks. They are not the customer's deposits with the institution.

As non-bank financial institutions are functionally different to banks, it would be inappropriate to regulate non-bank financial institutions on the same basis as banks.

3. Banks

Bank liabilities comprise more than 90 per cent of all money in the economy. Thus the stability of Australia's currency depends, to a large extent, on the stability of the banks. Therefore, it is essential that the authority responsible for the stability of Australia's currency, the Reserve Bank, be responsible for banks.

Banks' liabilities are commonly accepted as a medium of exchange. This general acceptance can only continue while the security of bank liabilities are not questioned. To maintain such a high standard, the prudential rules for banks should be more stringent than for non-bank financial institutions.

A non-bank financial institution does not need the same level of public confidence because only those people that wish to be creditors of that institution need be creditors. This differs from a bank where anyone who accepts cheques as a means of payment can be made a creditor of any bank.

4. Competition between Bank and Non-bank Financial Institutions.

Non-bank financial institutions have limited lending capacity. They can lend only what has been deposited or saved with them, either by creditors or shareholders. Non-bank financial institutions need to have money in the bank before they can lend. This is the main limit to their lending capacity. They may have minimum capital requirements, also, but such requirements are not the main constraint on their lending capacity.

Banks, on the other hand do not face the same constraint. They do not need "money in the bank" before they can lend. They do have a prime asset and weighted capital requirements. But these do not constitute a major impediment to bank lending. The prime asset requirement can be met by simply increasing lending to government. The capital requirement is being met by raising bank profits. Banks often find that the main constraint to their lending is the limited supply of "bankable" proposals.

Thus non-bank financial institutions have a competitive disadvantage in lending.

5. A Competitive Environment

We have seen that the economic roles of banks and non-bank financial institutions are quite different. Ideally, the two types of institutions should be able to compete equitably within the financial market, playing complementary roles.

Banks need to be regulated in a manner that is conducive to efficient operation of the whole economy, not just the financial markets. Therefore, it is first necessary to establish an environment in which the Reserve Bank has a means of implementing an effective form of monetary policy so as to achieve its objectives. It is only then that we can proceed to consider the forms of institutional arrangements that may be conducive to equitable competition in the broader financial market.

6. Facilitating Savings and Growth.

Part A of this submission explained how floating the exchange rate had eliminated exports as a source of monetary growth. This source of monetary growth constituted an increase in savings. Its elimination left bank credit as the main source of monetary growth in Australia. Bank credit was a source of monetary growth that caused dis-savings.

Part A also explained how the requirement of the floating exchange rate system to immediately balance international receipts and payments inflated the real exchange rate for countries, like Australia, had rising exports and were attractive to foreign investment. The inflated exchange rate was shown to reduce the rate of economic growth.

If Australia is to overcome such constraints to its rate of economic growth, it will need to remove the link between international currency transactions and the exchange rate. Australian exporters must be able to increase their exports without raising the exchange rate.

One way to cut the link would be to return to the fixed exchange rate system. However, Australian regulators have not been able to effectively manage the economy under that system. It is not a recommended option.

There may be a number of other ways of achieving such a stable exchange rate. The following method is provided as a suggestion of the type of arrangement that could be considered. It is based upon experiences in managing monetary growth in other countries. Some components have similarities to the approach of monetary boards in Hong Kong and, more recently, in Argentina. The proposed arrangement is called the Optimum Exchange Rate System.

7. The Optimum Exchange Rate System.

The Optimum Exchange Rate System has two major components:

- a mechanism for managing bank credit to prevent excessive lending; and
- an arrangement for managing the exchange rate to ensure sufficient demand for domestic products to provide full employment.

7.1 Managing Bank Credit

To explain the first part of the system, we will assume, initially, that the exchange rate is fixed.

The Optimum Exchange Rate System uses foreign reserves as the money base. Each bank is required to hold foreign reserves in its own right. The ability of each bank to increase its credit, or lending, is then tied to the growth of its net foreign reserves (foreign assets less foreign liabilities). If we

initially assume that there are no international capital flows, such a constraint would mean that banks could lend only while there were national savings.

If lending were excessive such that it caused imports to exceed exports, it would reduce the banks' foreign reserves. A fall in foreign reserves would constrain the banks from further lending until foreign reserves were replenished. Therefore, bank lending could not proceed until there was an increase in national savings.

The system requires inter-bank settlements to be made in foreign exchange. This would ensure that banks compete to attract deposits so as to gain, or retain, foreign reserves. Such an arrangement would ensure equity between banks, also. For example, banks that lent excessively would lose foreign reserves to other banks when the funds lent were deposited with other customers.

The way this system might work is that the Reserve Bank may authorise banks to increase their lending by, say, A\$10 for every US\$1 increase their net foreign reserves. Thus, if a bank increased its foreign reserves by the equivalent of US\$10 million, it would be authorised to lend an additional A\$100 million.

For example, the account shown as Case 3a, represents the initial position of a bank under this system. We will assume that US\$1 is equivalent to A\$1.50. With total lending at \$1,000 million (\$100 million to government and \$900 million to the private sector) the foreign reserve requirement would constrain the bank from increasing its total lending.

Case 3a

Assets	\$M	Liabilities & Equity	\$M
Government Securities	100	Customers' Deposits	1,050
Foreign Reserves	150		
<i>(equivalent to US\$100)</i>			
Loans Outstanding	900	Capital	100
Total	<u>1,150</u>	Total	<u>1,150</u>

We now assume that the bank's customers increase their exports by \$15 billion and deposit the funds earned with the bank. Its balance sheet is as shown in Case 3b.

Case 3b

Assets	\$M	Liabilities & Equity	\$M
Government Securities	100	Customers' Deposits	1,065
Foreign Reserves	165		
<i>(equivalent to US\$110)</i>			
Loans Outstanding	900	Capital	100

Total	<u>1,165</u>	Total	<u>1,165</u>
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The increased foreign reserves enable the bank to increase its lending. As it does so, its customers increase their spending, including spending on imports. We will assume that at the time the bank had increased its lending to \$20 million, spending on imports has increased by \$12 million and reduced foreign reserves to \$153 million, or US\$102 million. At this point the bank's lending is constrained until foreign reserves rise again.

Case 3c

Assets	\$M	Liabilities & Equity	\$M
Government Securities	100	Customers' Deposits	1,073
Foreign Reserves	153		
<i>(equivalent to US\$102)</i>			
Loans Outstanding	<u>920</u>	Capital	<u>100</u>
Total	<u>1,173</u>	Total	<u>1,173</u>

In economic terms, this means that exports have increased by \$15 million but imports have increased by \$12 million. Hence, there has been a net increase in national savings. Also, the export growth and the credit growth have increased national income without causing balance of payments problems. Therefore, this method of generating monetary growth is sustainable in the long term.

7.2 International Capital Flows

This approach does not mean that lending is totally constrained. The banks can raise their lending capacity by raising interest rates to attract foreign capital as shown in the following diagram.

In Figure 9, the supply of loanable funds from the banks is given by the S1-S1 schedule. The demand for loans is given by the D-D schedule. Interest rates are assumed to be initially at r_1 . At this rate of interest, the bank can lend only L1 but the demand for loans is at L3. Also, at this rate of interest there are no international capital flows.

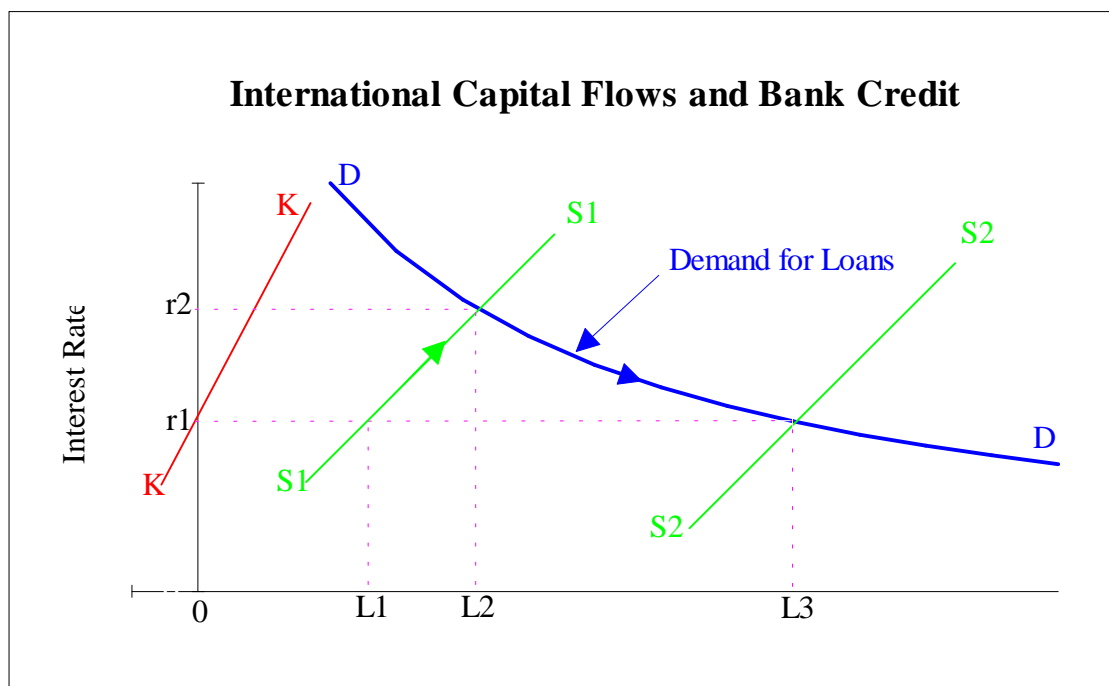


Figure 9.

If the banks raise interest rates to r_2 , they would attract foreign capital. This would increase their foreign reserves, enabling them to increase their lending to L_2 and clear the market.

When borrowers started to repay their loans, they would increase the banks' capacity to lend above demand at interest rate r_2 . In response to the excess lending capacity, the market would reduce interest rates. This reduction would extend the demand for loans and reduce the level of foreign capital inflow. The market would continue to reduce interest rates and expand lending until interest rates fell to r_1 . At this rate, the demand for loans would be fully met from domestic sources.

Under the floating exchange rate system, international capital flows tends to cause instability in the economy. But under the optimum exchange rate system, it contributes to stability.

Foreign investment inflates the exchange rate under the floating exchange rate system, increasing the demand for imports and reducing the demand for domestic products. That is, it reduces national income. Under the optimum exchange rate system, foreign investment reduces interest rates and enables the economy to enjoy a higher level of investment. Such investment would contribute to a higher level of national income.

7.3 The Optimum Exchange Rate.

Any economy could experience balance of payments stability under the monetary arrangements described above. Its foreign reserves would rise and, in the long term, its net foreign debt decrease. Interest rates under

these arrangements would be stable and would be expected to be close to world rates.

We have, up to now, assumed that the exchange rate was fixed. If the exchange rate were fixed at a high rate, it would make imports relatively cheap and domestic products relatively expensive. This is likely to cause unemployment. Such a case is shown in the following diagram.

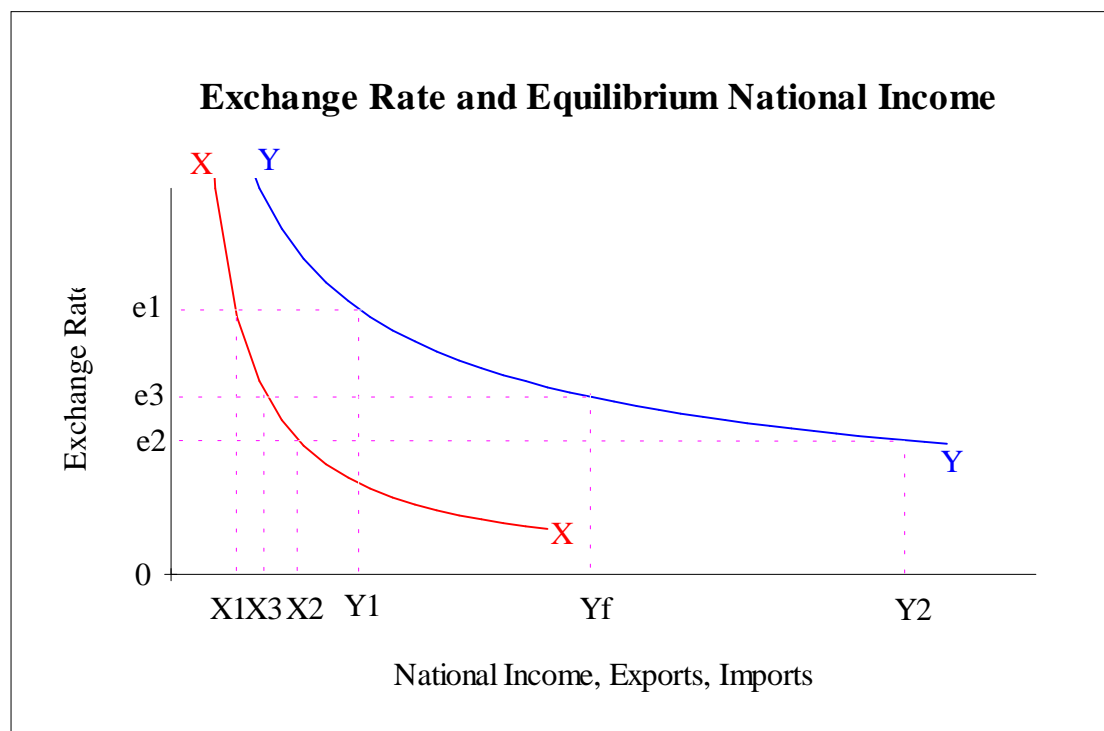


Figure 10.

In Figure 10, the amount of exports is given by the X-X schedule. Equilibrium national income is shown as the Y-Y schedule. Equilibrium exists when imports equal exports. The full employment level of national income is shown as the amount Yf.

If the exchange rate were at e1, exports would be at X1 and equilibrium national income at Y1. At this level of national income there would be unemployment.

If the exchange rate were at e2, exports would rise to X2 and equilibrium national income would be at Y2. This position of an undervalued exchange rate is likely to cause excessively high rates of employment and inflation. Inflation has the effect of inflating the real exchange rate.

If the exchange rate were set at e3, exports would be at X3, and at equilibrium, national income would be at the full employment level. Therefore, e3 would be the optimum exchange rate.

7.4 Exchange Rate Arrangements.

The optimum exchange rate system provides incentives to the foreign exchange market, principally the banks, to set the exchange rate at the optimum level to provide full employment. These incentives can take any form. However, the following is an example of the type of incentive I envisage. In this example, we will define full employment to mean less than 2 per cent unemployment,

As explained earlier, the banks are required to hold foreign reserves and to regulate the growth of their lending according to the growth of their net foreign reserves. If there were full employment, banks would be permitted to increase their total lending by, say, \$10 for every US\$1 increase in their net foreign reserves. If unemployment were greater than 2 per cent, then the banks would be required to reduce their rate of lending by, say, \$1 for each percentage point that unemployment exceeds 2 per cent.

Thus, if unemployment were 5 per cent, the banks would be permitted to increase their lending by only \$7 for each US\$1 increase in their foreign reserves. The effect of this is to raise foreign reserves as a share of total bank assets. Income from foreign reserve assets would be less than income from loans. Therefore, the effect of this policy is to raise the low income assets as a proportion of total bank assets and so reduce the bank's profits.

To avoid a reduction in profits, banks would seek to set the exchange rate at a level that would ensure full employment. If exchange rate needed to be changed to achieve such an outcome, the banks would change it.

Although the exchange rate is variable under this system, it is likely to be much more stable than under the floating exchange rate system. Banks would not need to deal in the foreign exchange market to buy or sell foreign exchange. Rather, they would provide an over the counter market in foreign exchange. Foreign currency payments would be made from their foreign reserves and foreign currency receipts would be paid into their foreign reserves.

With the optimum exchange rate system, banks would be likely to employ economists in economics sections to determine what the optimum exchange rate should be. These economic sections are likely to continually monitor economic activity with a view to adjusting the exchange rate if and when it was necessary to do so to maintain full employment.

The banks would buy foreign exchange in the wider market if they were of the opinion that the exchange rate was overvalued in that market and sell foreign exchange if they were of the view it was undervalued. Such action would have a stabilising effect on the wider foreign exchange market and so contribute to overall stability of the exchange rate.

7.5 Inflation

It is possible that under the arrangements proposed above, banks may prefer to undervalue the exchange rate to ensure full employment rather than fine tune the rates so as to attain the optimum exchange rate. This may cause inflation. To avoid such a situation, it is possible to modify the incentives to banks so that they are encouraged to minimise inflation, also.

For example, if the maximum acceptable rate of inflation were 3 per cent, banks would be encouraged to minimise excessive inflation if their ability to lend was reduced by, say, \$1 for each percentage point that inflation exceeds the maximum acceptable rate. Thus, if inflation were 6 per cent and unemployment 5 per cent, banks would be able to lend only \$4 for each US\$1 increase in their net foreign reserves.

7.6 Speculative International Capital Flows

Speculative international capital flows have been de-stabilising under both the fixed and floating exchange rate systems. But under the optimum exchange rate system, such speculation is unlikely to have any significant effect.

One of the largest speculative groups under the fixed exchange rate system was the banks. They had excellent information about activity in the foreign exchange market and had large liquid assets to move to take advantage of this knowledge. If they suspected a devaluation, they advised their customers to move their funds, also.

Under the optimum exchange rate system, the banks set the exchange rate. If there is any speculation, it would be against the banks. Thus, banks would have a stabilising role, rather than a de-stabilising role, in the foreign exchange market.

Banks would use their market knowledge to set the exchange rate at the most appropriate rate. Anyone speculating against the banks would need to have better knowledge than the banks if they were to speculate successfully.

Exchange rate adjustments under the optimum exchange rate system, when they do occur, are likely to be small. Thus the profits from speculation are likely to be small. This would tend to reduce the level of speculation.

The optimum exchange rate system gives banks large holdings of foreign reserves. This gives them the resources to defend the exchange rate that they set. Hence, speculators are unlikely to be able to force any movement in the exchange rate.

7.7 Qualitative Effects

The optimum exchange rate is likely to have qualitative as well as quantitative effects on lending. For example, if there were already full

employment in Sydney and unemployment in Adelaide, the banks would be more open to loans that increased investment and provided employment in Adelaide than in Sydney. Such an outcome improves resource utilisation and should be encouraged.

As credit growth is related to foreign reserves, banks are more likely to become active in promoting exports and import replacement industries. This may create a bias in bank lending towards these type of industries.

Also, with full employment and a more stable exchange rate, the economy is likely to grow more rapidly. This will increase demand for industrial investment. It is possible that banks will prefer to utilise their lending capacity for these larger projects.

Such changes should not cause a shortage of finance to other sectors. It may mean that non-bank financial institutions play a greater role in catering for the consumer and home mortgage market.

8. Institutional Arrangements

The optimum exchange rate system ensures that the monetary system serves the wider economy to:

- sustain full employment;
- facilitate higher rates of economic growth; and
- ensure external stability.

The system provides a basis for establishing clear roles for the institutions engaged in the financial market.

8.1 Government

The role of government in the monetary/financial market under the optimum exchange rate system would be to set the targets for employment and inflation. With the higher rates of economic growth, that are likely under the optimum exchange rate system, government revenues are likely to rise, and government expenditure with it. Even so, the rise in government revenue is likely to exceed the growth in government spending. Therefore, we could expect government budgets to be balanced, or in surplus. Hence, public debt would play a less significant role in the financial market.

8.2 Reserve Bank

Under the optimum exchange rate system, the Reserve Bank would set the ratio of bank lending to foreign reserves and enforce those rules. It would also establish, monitor and administer the incentives for full employment

and inflation. Its approach to monetary policy is likely to change from a "market oriented" strategy to a "management by objectives" strategy.

The Reserve Bank would lose its control over interest rates under these arrangements. However, as we have already seen, interest rates have been ineffective as an instrument of monetary policy in Australia and should be abandoned. The alternative arrangements proposed here would enable the Bank to more effectively regulate the economy so as to attain its statutory objectives.

8.3 Banks

Banks provide money to the economy. Money is the basic facility in the economy that enables trade across the national and with the rest of the world. The primary role of banking system is to provide this facility. In the process of providing it, banks are also required to prudently manage the assets (loans) that are the backing for the economy's money.

We have seen that bank lending activity has significant effects upon the economy. The proposed arrangements make banks more responsible for the consequences of their lending activities. Banks are motivated to ensure that the money supply the exchange rate are appropriate and conducive to full employment.

These changes would raise the standing of banks in the economy and the financial community. This is because banks would be responsible for changes in the exchange rate and interest rates. They would be responsible for unemployment and possibly inflation. These factors affect the lives and livelihoods of most Australians.

While bank activities have had a significant effect upon the economy, banks have not sought to manage these effects in the past. Under the optimum exchange rate system, banks would take a more pro-active stance in the economy. Their foreign exchange dealings and lending activities will be assessed for their consequences for the economy. Such changes should generate a more vigorous economy.

With a higher rate of economic growth, there would be greater demand for finance for large investments. Banks, with limits to their lending capacity, would tend to direct a large share of that lending capacity towards large profitable investment. That may mean that bank lending in other sectors may be less significant than at present.

8.4 Non-bank Financial Institutions

The role of non-bank financial institutions is to invest the "consumption savings" of the nation. Banks invest the national savings (or dis-savings).

We have seen that the lending activity of non-bank financial institutions do not affect the money supply or the current account. Therefore, they should be subject to less regulation than banks.

The objectives of any regulation of this sector would be to:

- protect the interests of depositors and other creditors; and
- encourage the development of a healthy financial market able to cater for a wide range of financial requirements.

9. Conclusion to Part B

The Australian Financial System Inquiry of 1982 (the Campbell Report) recommended the adoption of the floating exchange rate system and the deregulation of banking. This submission has revealed that the floating exchange rate system has brought about slow economic growth that has led to high unemployment. It has also constrained the growth of national savings. Also, this submission has shown that the indirect controls available to the Reserve Bank have been inadequate to control the monetary system and achieve the Bank's objectives for monetary policy.

The failings of the floating exchange rate system have been recognised for many years. One of the reasons given by Milton Friedman and others for advocating the system, despite its failings, has been that there were no alternative variable exchange rate systems. Part B of this submission has shown that there is more than one variable exchange rate system. Furthermore, it has shown that the alternative can deliver a more stable and prosperous economy than the floating exchange rate system.

This Inquiry is required to identify factors likely to drive further change in the financial system. Factors likely to drive further change in the financial system include:

- the constraints imposed upon the economy by the floating exchange rate system; and
- the lack of adequate regulatory arrangements to control the monetary aggregates.

These factors affect the real economy and, through that, the financial market. The slow rate of economic growth associated with the floating exchange rate system is hampering the development of the whole economy, including the financial system.

The inadequacy of the regulatory arrangements over the monetary system has led to the collapse of many businesses, including financial institutions.

It also resulted in a recession that made more than one million Australian workers unemployed.

These failings in the financial system need to be addressed.

This Inquiry is also required to make recommendations on the regulatory arrangements and other matters affecting the financial system. These recommendations are required to promote the most efficient and cost effective service for users consistent with financial market stability, prudence, integrity and fairness.

The current financial arrangements have been inefficient. They have not utilised the savings ability of the economy to maximise investment and economic growth. High interest rates have reduced savings in the form of loan repayments. They have also reduced investment. The current arrangements have also imposed massive costs upon the financial system, particularly the cost of bad debts from loan defaults caused by the high interest rates. Such defaults, in Australia and elsewhere, have caused central banks, including the Reserve Bank of Australia, to raise the minimum capital requirements for banks. This additional capital requirement has added to the cost of finance.

The current arrangements have also been unstable. Exchange rates and interest rates instability has caused instability in financial markets. Such instability increases risks in the market. Such risk is not conducive to prudent financial management.

Many Australian borrowers have suffered from high interest rates, which have increased the burden of their loans, and the high exchange rates, which have reduced their incomes. They have lost their properties, businesses or homes. Such outcomes do not improve the integrity or the fairness of the financial system. These outcomes have been unduly harsh.

Therefore, this Inquiry is required to make recommendations that will address these matters.

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